

Office of Chief Counsel
Internal Revenue Service
memorandum

CC:IT&A:BR6
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date: April 24, 2001

to: Thomas R. Roley
Director, Appeals LMSB (Operations)
C:AP:CIIT

from: Robert M. Casey
Senior Technician Reviewer, CC:IT&A:BR6

subject: Appeals Settlement Guidelines: Construction/Real Estate Industry -- Retainage Payable
SPR-104457-01

This memorandum responds to your January 22, 2001, request for comments concerning the above-referenced document.

The paper does not address the most important issue concerning the proper treatment of retainages – when is the all events test met. The paper assumes that the all events test is satisfied but fails to discuss the importance of contract terms in deciding when the all events test is met. The paper could leave readers with the incorrect impression that taxpayers must always take retainages into account when the related work is performed.

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Deliberative process privilege

Miscellaneous

Under the PCM, a taxpayer/contractor determines the current year's gross receipts from a long-term contract by multiplying the "total contract price" by the contract's "completion factor" for the current year ("cumulative gross receipts") and by subtracting from this amount the cumulative gross receipts for the immediately preceding year. The completion factor, which shows the percentage of completion, is the ratio of (1) the amount of allocable contract costs incurred by the end of the current year (the numerator) to (2) the estimated total contract costs (denominator). At issue in the ASG is when are amounts payable to subcontractors, as either a progress payment or as a retainage, incurred within the meaning of § 461, and thus, must be included in the numerator of the completion factor. Contract costs generally are treated as incurred in the taxable year in which the "all events" test of § 461 is met.

Section 461(a) of the Code provides that the amount of any deduction or credit shall be taken for the taxable year which is the proper taxable year under the method of accounting used in computing taxable income.

Section 461(h) of the Code and § 1.461-1(a)(2) of the regulations provide that, under an accrual method of accounting, a liability (as defined in § 1.446-1(c)(1)(ii)(B)) is incurred, and generally is taken into account for federal income tax purposes, in the taxable year in which (1) all the events have occurred that establish the fact of the liability, (2) the amount of the liability can be determined with reasonable accuracy, and (3) economic performance has occurred with respect to the liability. The first two requirements are referred to as the all events test. § 461(h)(4).

[REDACTED]

(Generally, the reasonable accuracy requirement of the all events test is not in dispute where the amount of liability can be determined from the terms of the contract.) If all the events that determine the fact of liability do not occur until a taxable year after economic performance is met, a liability is not incurred under § 461 until both of these requirements, as well as the reasonable accuracy requirement is met.

Where a taxpayer's obligations are set forth in a written agreement, the specific terms of the agreement are relevant in determining the events that fix the taxpayer's obligation to pay. See Decision, Inc. v. Commissioner, 47 T.C. 58 (1966), acq. 1967-2 C.B. 2. Although the ASG describes a "typical scenario" set of facts to illustrate its conclusions under an economic performance analysis, it does not include a description of contractual provisions relating to when the liability of the contractor is fixed either as to progress payments or retainages. In order to fully analyze when a liability is incurred, we believe the specific contractual provisions must be provided and analyzed. See Shepherd Construction Co., Inc. v. Commissioner, 51 T.C. 890 (1969), acq. 1969-2 C.B. xxv (in determining whether an accrual basis general contractor had incurred a

liability for retainages withheld from its subcontractors prior to final acceptance and approval of the work performed, court looked to specific terms of the contracts relating to acceptance). We believe the specific terms of contracts must be examined whether the all events test is at issue or whether economic performance is at issue. Relevant contractual provisions would include, for example, provisions concerning (1) whether the contract is for the provision of property, services, or both property and services; (2) the billing arrangements; (3) acceptance provisions; (4) retainage provisions; (5) conditions relating to progress or periodic payments.

If you have any further questions regarding §461, please call Susie K. Bird at 202-622-7881. If you have further questions regarding other issues, please call Leo Nolan at 202-622-8545.